

IT 96-41

Tax Type: INCOME TAX

Issue: Apportionment: One Factor/Three Factor Application
Penalty Under 1002(d) - Failure To File/Pay Withholding

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
ADMINISTRATIVE HEARINGS DIVISION
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE)	
OF THE STATE OF ILLINOIS,)	
Petitioner)	No.
)	
v.)	FEIN:
)	
TAXPAYER,)	
Taxpayer)	Linda K. Cliffler,
)	Admin. Law Judge
)	

RECOMMENDATION FOR DISPOSITION

APPEARANCES: Richard Hanson of McDermott, Will & Emery, for TAXPAYER; Robert Asbille, Special Assistant Attorney General, for the Illinois Department of Revenue.

SYNOPSIS:

The instant case arose as a result of an audit conducted by the Illinois Department of Revenue (hereinafter referred to as the "Department") of TAXPAYER (hereinafter referred to as "TAXPAYER" or "Taxpayer") for the years ended 12/31/89, 12/31/90 and 12/31/91.

A Notice of Deficiency was issued to TAXPAYER on March 9, 1994 in the amount of \$239,583 inclusive of interest and penalties. A timely protest was filed by taxpayer on May 4, 1994.

The issues presented for review are:

1. Whether the Department properly included income from taxpayer's investments in the sales factor.
2. Whether taxpayer offered evidence of reasonable cause sufficient to abate the Section 1005 penalties.

After protest and administrative hearing, it is recommended to the Director that the sales factor issue be resolved in favor of the Department, and that the Section 1005 penalties be abated.

FINDINGS OF FACT:

1. TAXPAYER is a Delaware corporation with its headquarters in Chicago, Illinois. (Taxpayer's Protest)

2. Taxpayer is engaged in the business of producing crude oil and natural gas and has oil field facilities and equipment in Kansas, Texas and Oklahoma. In recent years as much as one-half of taxpayer's income came from investments. (Tr. p. 24)

3. Taxpayer contracted with BANK of Chicago ("BANK" or "bank") to manage its portfolio. (Tr. pp. 26, 27; Joint Ex. 1-A)

4. BANK had authority to invest in short-term investments without taxpayer's approval. (Tr. p. 27, 31) Short-term investments consist of money market funds, high grade commercial paper and short-term treasuries. (Tr. pp. 35)

5. WITNESS, taxpayer's Vice President & Treasurer, retained approval authority for all long-term investments. (Tr. p. 33)

6. Taxpayer defined long-term investments as including all fixed income investments with a maturity of 6 months or more plus any equity security (i.e., stock). (Tr. p. 29)

7. WITNESS sets goals for the investment managers, monitors the performance of the bank and approves long-term investments that are proposed by the bank. (Tr. pp. 25-26) He also established guidelines with the bank concerning bond maturity dates and ratings. (Tr. pp. 16-17)

8. BANK would prepare a booklet of its investment proposals which it would present to WITNESS 5 to 6 times per year. (Tr. p. 37)

9. WITNESS meets with the employees of the bank several times a year to review investment strategies. (Tr. pp. 32-33)

10. WITNESS spends 10% to 15% of his time overseeing the bank's investment activities. (Tr. pp. 26, 31) He spends 3 to 4 hours every Saturday morning reviewing the stock market, reading and charting. (Tr. p. 30)

11. The majority of the taxpayer's portfolio is in long-term investments. (Tr. p. 30).

12. During the audit period the value of taxpayer's portfolio was between \$44 and \$55 million. (Tr. p. 40)

13. The following is a comparison of the product sales (oil and gas income) and interest income from the investment fund.

	<u>12/31/89</u>	<u>12/31/90</u>	<u>12/31/91</u>
Product Sales	\$2,725,121	\$3,154,408	\$1,595,580
Interest	3,025,265	2,589,553	2,917,116

(Dept. Post-Hearing Brief)

CONCLUSIONS OF LAW:

1. Sales Factor

Historically, TAXPAYER's primary trade or business has been oil and gas production. In recent years, however, a substantial part of its income has been from its investments. Taxpayer has classified its income from investments as business income and excluded the investment income from both the numerator and denominator of the sales factor.

On audit, the Department increased the numerator and the denominator of the sales factor by the interest and dividend income.

According to 35 **ILCS** 5/304(a) business income will be apportioned to Illinois on the basis of the three-factor formula (with limited exceptions). The denominator of the sales factor is "total sales of the person everywhere during the taxable year." 35 **ILCS** 5/304(a)(3)(A). The numerator of the sales factor includes all sales of tangible personal property in this State and

Sales, other than sales of tangible personal property are
in this State if:

(i) The income-producing activity is performed in this State; or
(ii) The income-producing activity is performed both within and without this State and a greater proportion of the income-producing activity is performed within this State than without this State, based on costs of performance.
35 ILCS 5/304(a)(3)(C).

Departmental regulations provide more detail regarding computing the sales factor (See 86 Admin. Code ch. I, Sec. 100.3370). Section 100.3370(2)(c)(3) states:

The sales factor includes gross receipts from transactions other than sales of tangible personal property ... gross receipts are attributed to this state if the income producing activity which gave rise to the receipts is performed wholly within this state.

A) Income producing activity defined. The term "income producing activity" applies to each separate item of income and means the transactions and activity directly engaged in by the person in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit. Such activity does not include transactions and activities performed on behalf of a person, such as those conducted on its behalf by an independent contractor. The mere holding of intangible personal property is not, of itself, an income producing activity. Accordingly, the income producing activity includes but is not limited to the following:

i) The rendering of personal services by employees or the utilization of tangible and intangible property by the person in performing a service....

The income producing activity which gives rise to the interest and dividends is the investment of taxpayer's portfolio. While taxpayer has contracted with BANK to manage its portfolio, BANK is subject to substantial restrictions on its authority. The Vice President and Treasurer of the taxpayer, WITNESS, establishes the objectives for its investments, identifying acceptable risks and maturity dates, and retains approval authorization of all long-term securities (debt securities with maturities of more than 6 months and all equity securities).

Taxpayer argues that the income from these intangibles should be "thrown out" of the sales factor since the income results from the "mere holding" of the intangibles by the taxpayer.

The question of what constitutes "mere holding" is an issue of first impression in Illinois. The language in Regulation Section 100.3370(2)(c)(3), cited above, comes from the Multistate Tax Commission regulations. In discussing the apportionment of interest income, the Multistate Corporate Income Tax Guide states:

Despite UDITPA's inclusion of all dividend and interest income in the denominator of the sales factor..., the MTC regulations carve out a substantial exception. Under "special rules," the regulations exclude from the sales factor (denominator) "business income from intangible property [that] cannot readily be attributed to any particular income-producing activity of the taxpayer." Included in the examples provided to illustrate an absence of the requisite connection with the taxpayer's activity are dividends or interest that result "from the mere holding of the intangible personal property of the taxpayer...." What constitutes the "mere holding" of intangibles is not explained in the regulations or thus far by case law.
(CCH Multistate Rptr. 2164, July 1994)

Since we have no definition of "mere holding" we must look at the plain meaning of the words. According to Webster's New Dictionary of the English Language, "mere" means "nothing more than what is specified." "Hold" is defined as "[t]o have and keep in possession" and "[t]o own." Mere holding, then, means nothing more than possession, a passive ownership. The activities of WITNESS go beyond mere holding. He establishes the investment objectives, monitors the results of the bank's investments, and approves the long-term transactions, which make up the bulk of the taxpayer's investments.

Receipts from intangibles must be thrown out of the sales factor only in the limited circumstance where business income cannot be identified with any income producing activity of the taxpayer. It is easy here to locate the income producing activity of the taxpayer: WITNESS's activities occur in Illinois and the commercial domicile of the taxpayer is in Illinois. Clearly, the income from the investments of the taxpayer should be included in both the numerator and denominator of the Illinois sales factor.¹

¹ If the "mere holding" standard were to apply in this case, it would lead to the absurd result that because the investment income has been determined to be

Based on the evidence presented, I find that the taxpayer engaged in sufficient income-producing activity in Illinois to exceed the "mere holding" threshold, and consequently, taxpayer's investment income should be included in the sales factor.

2. Section 1005 Penalty

Taxpayer has requested an abatement of Section 1005 penalties due to reasonable cause. Section 1005 of the Illinois Income Tax Act provides that:

...If any amount of tax required to be shown on a return prescribed by this Act is not paid on or before the date required for filing such return (determined without regard to any extension of time to file), a penalty shall be imposed at the rate of 6% per annum upon the tax underpayment unless it is shown that such failure is due to reasonable cause. This penalty shall be in addition to any other penalty determined under this Act...

Under federal case law, "reasonable cause" includes taking a good faith position on a tax return. See I.R.C. Section 6664(c). In general, if there is an honest difference in opinion between the taxpayer and the IRS regarding the correct amount of tax, no penalty is imposed. As a result, no penalty would be imposed due to a deficiency arising from a good faith tax return position with regard to law or facts. See, Ireland v. Commissioner, 39 T.C. 978 (1987); Webble v. Commissioner, 54 T.C.M. 281 (1987); Balsamo v. Commissioner, 54 T.C.M. 608 (1987).

As to the Section 1005 penalty for the years at issue, taxpayer's position on its tax returns was that its investment income should be excluded from the sales factor since it resulted from the "mere holding" of an intangible. While I disagree with taxpayer's position, and have found sufficient activity by taxpayer to exceed "mere holding," taxpayer's position was taken in good faith due to the lack of authority as to what constitutes "mere holding." Consequently, taxpayer has offered reasonable cause to abate the Section 1005 penalty.

business income, none of it would be included in the sales factor, but had this income been treated as nonbusiness income, 100% would be allocated to Illinois.

WHEREFORE, for the reasons stated above, it is my recommendation that the Notice of Deficiency should be finalized as to the inclusion of investment income in the sales factor.

The taxpayer has offered sufficient evidence of reasonable cause to abate the Section 1005 penalties.

Date:

Linda K. Clifffel
Administrative Law Judge